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# Why the People Who Broke the Financial System Will Profit

By 24/7 Wall St.

*"Never underestimate the capacity of angry populism in times of economic stress,"*
— Robert Reich, The New York *Times*, March 15, 2009

The profligate investment practices of the financial sector not only caused the current credit crisis but also allowed for the inappropriate compensation decisions of companies like American International Group and Merrill Lynch. Many would argue that the absence of effective regulatory oversight also contributed to both of these problems. However, equating these misdeeds with the financial system itself poses a grave risk to the economy's recovery.

Despite the public's justifiably poor opinion of many of the actors that inhabit the financial sector, spreading the blame will only hasten the economy's decline. In order for the economy to recover, the market must recover. And in order for the market to recover, America's antipathy toward the financial system must pass. (See pictures of the Top 10 scared traders.)

There has been a populist uproar over executive compensation paid to management at companies that have received financial assistance from the government bailout. These bonuses continue to receive enormous coverage in the media, inflaming the passions of voters and politicians alike. Informed by this sentiment, a New York *Times*/CBS Poll conducted in February found that "83 percent of respondents said the government should cap the amount of compensation earned by executives of companies that are getting federal assistance."

Less than two weeks ago, The Washington *Post* published an article announcing that AIG had paid millions of dollars in retention bonuses to executives of the company. Documents later turned over to the Connecticut Attorney General show that the actual figure was $218 million. To date, the government has loaned AIG $170 billion from various financial assistance efforts, including Troubled Asset Relief Program ("TARP"), in exchange for an 80 percent stake in the company. However, in apparent disregard of its unmatched failure, AIG chose to honor its employee's compensation agreements, and awarded multi-

million dollar bonus to its executives.

Edward Libby, AIG's government appointed CEO, has argued that these were retention bonuses, contractually guaranteed to employees who remained with the company. It has been further argued, on his behalf, that the bonuses are exempted by the American Recovery and Reinvestment Act, which provides that restrictions on bonuses do not apply to those made under an employment contract executed before February 11, 2009. The public seems unwilling to consider his arguments.

Last year AIG admitted that the company's Financial Products division entered into credit default swap agreements with banks that bought and securitized loans. CDS are a financial instrument that mimics the characteristics of an insurance contract. These instruments were most exposed to risk when the securitization market blew up following the housing market collapse. Not only is the company almost entirely owned by the government, but many of the executives receiving the bonuses are the same executives that marketed the CDS agreements that caused its downfall. (Read "Treasury Learned of AIG Bonuses Earlier Than Claimed.")

Some of AIG's payouts were retention bonuses, the latest tin-eared act of the large insurance company. In light of the injury AIG caused the economy and the debt it owes to the government, many see these actions as an abnegation of the company's duty to reasonably compensate their employees. Responding to the public's outcry about the AIG compensation disclosure, members of the House and Senate, along with the Treasury Department, have proposed a motley mix of measures seeking to counteract these bonuses.

Obama was among the first to cry foul, instructing Treasury Secretary Geithner to "block these bonuses and make the American taxpayer whole." Afterwards, in a letter to Congress, Geithner stated that "we will impose on AIG a contractual commitment to pay the Treasury from the operations of the company the amount of the retention awards just paid." It appears that AIG's penalty will be that the Treasury will force the insurance company to pay the Treasury back with money the Treasury has already given it. Congressman Barney Frank struck a strident tone when he proposed that the government enforce its right as owners of the company. In a briefing, Frank contended that the government should exercise this right as the majority shareholder and deny payment for breach of contract. In an appearance on *Face the Nation*, Frank proposed that in order to exercise these rights, "what we ought to be doing is suing as a shareholder, saying, 'look these are people who were paid bonuses that they weren't entitled to.'"

Last week, marked by uncharacteristic speed, the House passed a bill that would impose 90 percent surtax on bonuses paid to employees of companies that have received at least $5 billion in TARP funds if the employee's family income exceeds $250,000. In support of the bill, Obama said he is eager to receive legislation "that will serve as a strong signal to the executives who run these firms that such compensation cannot be tolerated." The Senate plans to vote on the bill this week.

Except for some contract lawyers, very few people would argue that the portion of the AIG bonuses that was for employee retention are fair. The only reason the company isn't in receivership is because the

government deemed it was "too big to fail." Fearing the financial market would be dealt a horrible blow if it went bankrupt, the government has provided AIG with several loans to prevent its untimely demise.

See the 25 people to blame for the financial crisis.

Recently, Andrew Cuomo, The New York Attorney General, announced that "Of the $165 Million pool, we calculate that employees have agreed to return approximately $50 million." This reflects about 20 percent of the $218 billion that Connecticut's Attorney General has said AIG paid in bonus compensation, but it's an impressive start.

President Obama, in an interview on *60 Minutes*, indicated that cooler heads were prevailing. Although he took pains to take AIG and Wall St.'s actions to task, he also suggested that the proposed bill from Congress would use the tax code to penalize a specific subset of people and would be contrary to good public policy. "Well, I think that — as a general proposition, you don't want to be passing laws that are just targeting a handful of individuals. You want to pass laws that have some broad applicability. And as a general proposition, I think you certainly don't want to use the tax code to punish people." He later went on to say, "Main Street has to understand, unless we get these banks moving again, then we can't get this economy to recover. And we don't want to cut off our nose to spite our face." (See pictures of Barack Obama's family tree.)

But, for all the press coverage, the AIG compensation matter is a sideshow because the economy remains in a nosedive. The current financial difficulties makes retroactively changing agreements between the government and private companies a risk as the Administration tries to enlist private enterprise to help consumer lending by reinvigorating the securitization market.

Judging by current unemployment figures and mortgage delinquency rates the economy is getting worse as each month passes. According to TransUnion, a leading consumer credit reporting agency, mortgage loan delinquency, traditionally seen as a precursor to foreclosures, increased for the eighth quarter in a row. This statistic is up approximately 53% from the same period last year. Likely contributing to that rise, unemployment rose in February from 7.6 to 8.1%. And a new Reuters poll of economists forecasts that unemployment will top 10% as early as next year.

Worse still is the availability of credit in the economy in general. According to the New York *Times*, "By one estimate, as much as $1.9 trillion of lending capacity — the rough equivalent of half of all the money borrowed by businesses and consumers in 2007, before the recession struck — has been sucked out of the system." Based on these figures the government's programs have yet to reach the American public.

**Banks & Toxic Assets**

Before 1970, banks were content to make loans to consumers and business which remained on their books, collecting interest until the principal on the loan was satisfied. This approach made for a relatively illiquid

market for the buying and selling of loans. Accordingly, this system insured that lenders were unable to sell their loan portfolios easily. Market illiquidity exposed the lender to the risk that individual loans would default or that rising interest rates would force the lender's interest cost higher than its income on the individual loan.

Asset backed securities ("ABS") gave banks the opportunity to bundle loans into a pool that could then be sold to other banks. The bank purchasing the loans would then hold them as an investment or resell them in the secondary market. This market improved the ability of banks to lend by transferring the risk of the loan default to a third party while providing financing to the bank to make new loans. In time, the public grew accustomed to the increased availability of credit. (See pictures of the printing of money.)

The purpose of Emergency Economic Stabilization Act, known as the bailout plan, was to restore stability and liquidity to the U.S. financial system. The TARP, one of the Act's driving initiatives, was intended to be a mechanism for financial institutions to offload toxic assets, in general, heavily leveraged ABS securitized by banks and held on their books. An ABS is considered a toxic asset when the value of the ABS is less than the original investment. The toxic asset has a negative impact on the bank's balance sheet which, when multiplied, reduces the banks ability to lend.

As an example, many Mortgage Backed Securities ("MBS"), a species of ABS, became toxic following the collapse of the housing market. Like all ABS, MBS derive their value from underlying loans, in this case, mortgages. A large group of mortgages provides the payment stream to the holders of ABS in the form of individual interest and principal payments made by a borrower to the bank.

As a result of declining home prices, if a borrower defaults on their mortgage, market prices for the home would be less than the balance on the mortgage. However, since MBS derive their value from a pool of loans — typically thousands of individual mortgages — the default of some portion of the mortgages would not mean the security had no value, only a reduced value. Unfortunately, banks, in an effort to increase their investment returns, exacerbated the problem by using enormous leverage to purchase and securitize mortgage loans. Thus, even if MBS's value declined because of defaults, because of the use of leverage, the security could still be toxic to the bank.

Finally, the seemingly unprecedented drop in prices together with increased default rates made it nearly impossible to assign value to MBS. As a consequence, MBS that had some intrinsic value were illiquid, and banks were forced to keep the toxic assets on their balance sheets.

See the best business deals of 2008.

See the worst business deals of 2008.

The principals behind TARP were relatively simple. The toxic assets on the bank's books prevented banks from making loans to businesses and consumers. Initially, TARP's purpose was to purchase the toxic assets

from the banks in exchange for financing from the Fed. However, in practice, valuing the assets became a nightmare. In order to account for this concern, revised versions of TARP extended credit to banks in exchange for an equity position — again, in an attempt to shore up the banks faltering balance sheets and encourage lending. This financing strategy granted equity to the government, thereby creating the possibility that taxpayers could benefit from the investments made on their behalf if the value of the investment in the banks eventually moved up. (Read: " Banks Left Out of TARP Bailout Could Face Extinction.")

The TARP investments have yet to bear fruit. Although it may have improved the financial stability of the banking sector and, certainly in the case of AIG, staved off certain bankruptcy, it has failed to encourage banks to meaningfully increase loans to consumers and small businesses. As a result, while banks may be able to remain stable, their stability does the consumer no good. Effectively, the bailout was a bailout of the banking system and its bad bets.

TARP was unable to stimulate lending because it only provided support to the banks. By injecting fresh capital into the system, the expectation was that once the banks were stabilized, they would be willing to start lending again. That simply has not happened.

One reason that TARP was unable to stimulate lending is because banks are only half of the lending market. Unless banks are able to securitize loans that can be sold to investors, loan originators will have insufficient capital to begin lending at healthy levels. In order for these loans to be securitized, private investors must be willing to purchase the securities. To date, these investors have remained on the sidelines, wary of the safety of these bets.

Recently on *60 Minutes*, Fed Chairman Ben Bernanke was asked what the first signs of the recovery would be. "Well, I think one sign would be that a large bank is successful in raising private equity. Right now, all the private money is sitting on the sidelines saying, 'We don't know what these banks are worth. We don't know that they're stable.' And they're not willing to put their money into the Bank."

**Securitization & Private Capital**

The Term Asset-Backed Securities Loan Facility ("TALF"), also known as the consumer loan program, is designed to increase consumer and small business loans by facilitating the securitization of certain loans offered by banks to the public. Specifically, TALF will encourage the securitization of these loans by lending up to $200 billion to investors of AAA-rated ABS. In order to encourage these private investors, including hedge funds, private equity funds, and other sophisticated investors, the loans provide unbelievably favorable terms. First, the effective interest rates of the loans will be incredibly low, currently as low as 2%. Second, unlike lending terms that the public has access to, prepayment of the loan is permitted without penalty. Third, as non-recourse loans, the investor can surrender the collateral, the ABS, in lieu of repaying the debt. Finally, in the event the collateral decreases in value, the Fed will not seek additional collateral to make up the difference.

In theory, investors, buoyed by the promise of these highly attractive loans, will purchase ABS, thereby creating demand for securitizers to issue new ABS. Once securitizers can begin issuing new ABS, they can go back to the bank, the loan originator, and purchase more loans for securitization. And, once banks are able to begin selling their loans to securitizers, they will be able to finance more consumer loans. Or, so the theory goes. (See pictures of the global financial crisis.)

In reality, because TALF investors are exposed to both economic and political risks, the success of the program is far from certain. The application of TALF is subject to a number of economic realities, any one of which could forestall the revitalization of the secondary market. Among TALF's requirements is that eligible loans must be backed by ABS that are AAA-rated by at least two rating agencies, like Moody's or Standard & Poors. Although a AAA-rated security would seem to be a safe bet, the rating agencies failure to properly rate ABS is one of the central reasons why so much bad debt ended up on the books of financial institutions in the first place. The market has yet to see any evidence that the agencies methodologies have meaningfully changed. This raises the question: why would investors purchase loans rated by a private company that has such a lousy track record?

Yet another issue which TALF will be unable to address is the sustainability of the secondary market. Prior to the market's collapse, these instruments were purchased by investors, re-securitized into new ABS, and resold in the secondary market. Although TALF has effectively created virtually risk free loans to investors, there is no incentive or protection for subsequent purchasers of the ABS. In the event the ABS purchased by the investors are unable to be repackaged and sold, the investor's incentive to purchase them is dramatically reduced. And, because it is unlikely that investors intend to treat the ABS as a long-term investment, absent this secondary market, investors will be disinclined from taking on the risk, however small it may be.

Finally, the required AAA-rating poses a significant limitation on the number of loans that can be securitized and purchased by investors with the Fed's financing. Individual AAA-rated loans represent only a fraction of all loans made to consumers. Prior to the credit crisis, a securitizer could improve the credit rating of an ABS whose underlying loans were lower than AAA-rated by taking out an insurance policy from a monoline insurance company. The policy provided that, in the event the underlying loans default, the policy guarantees the principal and interest of the ABS to the investor. Problematically, as of this year, there are no monoline insurers that have a AAA-rating by more than one rating agency. Thus, monoline insurance no longer serves as a viable credit enhancement technique. Furthermore, even if they were AAA-rated, TALF precludes their use for the purpose of credit enhancement.

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There are other credit enhancement techniques which securitzers have employed to improve the credit rating of ABS. Because individual AAA-rated loans are, by themselves, in the minority, in order to create AAA-rated ABS, a securitizer would bundle loans of different ratings and place those same loans into

different investment classes, known as tranches. Although the individual loans that comprise the tranches remain disproportionately below AAA-rated, because of how tranches work, they will receive different credit ratings, some AAA-rated.

Without other credit enhancement techniques, tranches are rated differently because each one is paid sequentially, with interest and principal payments on the underlying loans first going to the senior most tranche and the last payments going to the most junior. Effectively, the tranches are, at least in part, rated differently based upon the order in which they receive payment from the underlying loans. In the event of default, the junior most tranche may receive less than their regular return because they are the last tranche to be paid. In order to compensate for the increased risk, the more junior the tranche is, the higher the yield on the investment. Employing this system, loans that individually had varying credit ratings were bundled and tranches were created that were then sold in the secondary market.

Under TALF, the Fed will only finance AAA-rated ABS. Investors are not given an incentive to purchase the riskier tranches. The result is that securitizers would have to keep the riskier tranches on their own balance sheet. And, given banks recent experience with this approach, it is unlikely that they will be eager to do so again. However, in the event a bank wishes to act as a securitizer, they will have no choice.

Nonetheless, despite these obstacles, TALF could succeed in restoring the secondary market for ABS. Although rating agencies have yet to demonstrate that they can accurately assess the credit risk of these instruments, changes in the economy or regulatory action could alter this perception. And in the secondary market, buyers' concerns of ABS resold by investors may be mollified by their ability to secure relevant data on the underlying assets. For home loans, which will be eligible for securitization in future versions of TARP, this data could include the average FICO score of the borrowers, location of the property, the loan-to-value ratio of the loan, and whether the property is occupied. And, arguably, in the event faith is restored in the AAA-rated ABS market, liquidity for lower rated ABS may follow suit.

Unlike economic risks that TALF may be exposed to, political risks may pose a greater threat because they are less susceptible to accurate forecasting. The furor over AIG bonuses demonstrates that the political attitudes of the administration and the legislature are subject to the vagaries of populist outrage. The proposed legislation to impose a tax of 90 percent on the retention bonuses received by AIG executives, currently before the Senate, calls the sanctity of private contracts into question. It demonstrates that the government may retroactively alter the terms of financing agreements between it and private companies. It is likely that these events may cause private investors to reexamine whether they want to participate in TALF. If they believe that these financing agreements could expose them to a similar pattern of attack, they may choose not to participate.

If TALF can reestablish liquidity for ABS in the secondary market, it is likely that investors, including hedge funds and private equity funds, could make a great deal of money. That could cause the public to question why a wealthy financial manager makes millions of dollars from the arrangement while the taxpayer gets very little. That may very well stir memories of excessive AIG compensation in a year or so. Ironically, the

success of the secondary market may pose the greatest threat to its revitalization.

Finally, the nature of assistance and type of recipient make TARP and TALF wholly different programs. Under TARP, the government encouraged and even forced banks to accept financing because their financial position was so precarious it was threatening the stability of the entire market. Conversely, under TALF, the Fed and Treasury are seeking to persuade private investors to purchase assets from banks. Although these private investors were an integral part of the issuance of these instruments in the past, they are not seeking assistance from the government. Instead, they have been presented with an opportunity to invest in an uncertain market that the government hopes will revitalize consumer lending.

Many of the best traders and analysts on Wall St. have left their firms to avoid pay restrictions like the ones imposed on AIG executives. These traders have decamped to hedge funds and private equity firms. In their new jobs, they can take advantage of the government's programs to buy newly financed assets and, if the value of that paper improves along with the market's liquidity, the profits from the transactions could be stupendous. As the value of toxic assets comes full circle, many of the people who helped break the system can make huge sums while they help fix it.

— *Ash Allen*

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